KENYATTA UNIVERSITY

UNIVERSITY EXAMINATIONS 2017/2018

SECOND SEMESTER EXAMINATION FOR THE DEGREE OF BACHELOR OF ECONOMICS, BACHELOR ECONOMICS AND FINANCE, AND BACHELOR OF ECONOMICS AND STATISTICS

EAE 401: MONETARY THEORY AND POLICY

DATE: Monday 16th July 2018 **TIME: 4.30p.m - 630p.m**

INSTRUCTIONS:

Answer question one and any other two.

Question one is compulsory and carries 30 marks.

All other questions carry 20 marks each.

QUESTION ONE (COMPULSORY) - 30 MARKS

a) The table below shows factors affecting the monetary base, the money multiplier and money supply. Fill in the table by indicating the effect (***increase, unchanged or decrease***) for each factor on the monetary base money multiplier and money supplier.

[5.25 marks]

Factors Affecting the Monetary base, the Money Multiplier, and the money Supply			
	Effect on monetary base	Effect on monetary multiplier	Effect on monetary Supply
An increase in the reserve-deposit	------------	------------	------------
An increase in the currency-deposit ratio	------------	------------	------------
And open- market purchase	------------	------------	------------
An open-market sale	------------	------------	------------
An increase in reserve requirements	------------	------------	------------
An increase in discount window borrowing	------------	------------	------------
An increase in the discount rate		------------	------------

b) Demonstrate graphically and explain the effect of each of the following on the LM curve:

   i) The country's central bank decreases the money. [2.25 marks]

   ii) The country's interest rate increases. [3.5 marks]

c) "Overshooting is the basis of the enhanced effectiveness of monetary policy under floating exchange rates," Do you agree or disagree? Explain. [4 marks]

d) How does a central bank's foreign exchange market intervention alter the monetary base and the money stock? [4 marks]

e) What are the main assets and liabilities of central banks, and who owns and manages central banks? [5 marks]

f) If the cash-to-deposit ratio is 0.2 and the reserve requirement is 0.1, what happens to the money supply when the Central Bank sells $100 worth bonds? [4 marks]

g) What is the LM schedule, and what factors determine its position. [2 marks]

QUESTION TWO

a) Why does Friedman's view of demand for money suggests that velocity is predictable, whereas Keynes's view suggests the opposite? [8 marks]

b) i) Determine the optimal strategy for cash management for a person who earns Ksh160,000 per month, can earn 0.5 percent interest per month in a saving account, and has a transaction cost of ksh100. [4 marks]

   ii) What is the individual's average cash balance? [4 marks]

   iii) Suppose income rises to Ksh180,000. By what percentage does the individual's demand for money change? [4 marks]

QUESTION THREE

a) Milton Friedman states, "Money is all that matters to nominal income." How is this statement built into the aggregated demand curve in the quantity theory framework? [6 marks]

b) Franco Modigliani found that the most important transmission mechanisms of monetary policy involve consumer expenditure. Describe how at least two of these mechanisms work. [4 marks]

c) What is a target-zone arrangement? What are the benefits and costs of participating in one? [10 marks]

QUESTION FOUR

a) Why do economists focus on historical episodes of hyperinflation to decide whether inflation is a monetary phenomenon? [3 marks]

b) Why should a rise in the price level (but not expected inflation) cause interest rates to rise when the nominal money supply is fixed? [3 marks]

c) Under what circumstances will a central bank utilizing an interest rate based monetary rule to stabilize the economy fail in its objective of raising output? [9 marks]

d) State five main practical functions of a typical central bank. [5 marks]

QUESTION FIVE

a) What is monetarists' approach to the phenomenon of inflation? Is inflation always and everywhere a monetary affair? [9 marks]

b) Explain the difference between the Inventory Theoretical Approach and the Portfolio Optimization Approach to demand for money. How do these approaches signify the improvement on the Keynesian theory of demand for money? [12 marks]